

# Jersey & Guernsey Law Review – February 2008

## SHORTER ARTICLES AND NOTES

### UNFAIR PREJUDICE RELIEF IN JERSEY

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#### Introduction

1 Many jurisdictions provide shareholders with a legal right to seek relief where their interests, or those of the company, have been harmed by the company's controllers. Central to the operation of this protection in many countries – including Australia, the United Kingdom, Guernsey and Jersey – is the concept of “unfairly prejudicial” conduct. Article 141 of the Companies (Jersey) Law 1991 provides that “[a] member of a company may apply to the court for an order under Article 143 on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or some part of its members”. If the application under article 141 is well founded, article 143 provides the court with a broad discretion to “make such order as it thinks fit for giving relief in respect of the matters complained of”.

2 Articles 141 and 143 – Jersey's unfair prejudice remedy – have been considered by the Privy Council in *Gamlestaden Fastigheter AV v Baltic Partners Ltd.* [\[1\]](#) This short article analyses the Privy Council's decision and considers its likely impact on the development of Jersey's unfair prejudice remedy. The Privy Council's opinion will, however, be of wider interest because the UK's unfair prejudice remedy was considered and also because of the propensity with which courts in other countries refer to unfair prejudice decisions from other jurisdictions.

#### The unfair prejudice remedy

3 Articles 141 and 143 are modelled on the UK's unfair prejudice remedy, now found in sections 994 and 996 of the Companies Act 2006 but formerly sections 459 and 461 of the Companies Act 1985. In Jersey and the UK, the task of defining the concepts of unfairness and prejudice was left to the courts. Similarly, the courts were required to map the boundaries of the *qua* member rule: the requirement, under article 141 and sections 459 and 994, that unfairness must prejudice the shareholder in his capacity as a shareholder of the company. There are relatively few decisions concerning articles 141 and 143 and in those cases that have been heard in Jersey, English decisions under section 459 have been highly influential. [\[2\]](#) A short overview of the development of section 459 – which has been restated, without changes, as section 994 in the Companies Act 2006 – is therefore required

because this will place the English jurisprudence into context, particularly with regard to the policy issues that have shaped the remedy's development. It is, moreover, essential to make several observations concerning the Jersey courts' reliance on English authorities. After doing so, *Gamlestaden* will be discussed and its implications highlighted.

4 The UK's unfair prejudice remedy was first introduced by the Companies Act 1980. It replaced section 210 of the Companies Act 1948 which provided shareholders with relief in respect of oppressive conduct. The scope of section 210 was severely limited by narrow judicial interpretation. In contrast, section 459 has been interpreted purposively, thereby transforming the rights of shareholders, particularly in small, closely held companies. The courts have held that a wide range of conduct is capable of being unfairly prejudicial, including breaches of directors' duties, exclusion from management, serious mismanagement and the payment of excessive remuneration. Consequently, section 459 has, in practice, largely replaced other shareholder remedies including the derivative action and winding-up on just and equitable grounds.<sup>[3]</sup> Its popularity (as section 994) is unlikely to wane following the introduction of a statutory derivative action under Part 11 of the Companies Act 2006. This is because of the wide discretion the court enjoys under section 996 and also because a successful section 994 action can be founded in circumstances where a shareholder may be precluded from bringing a derivative action on the company's behalf.

5 The most important section 459 decision is *O'Neill v Phillips*,<sup>[4]</sup> in which Lord Hoffmann, delivering the only reasoned opinion, articulated a twofold test of unfairness which stressed the contractual basis of the shareholders' association. In his Lordship's view, unfairness arises where (1) there is a breach of the terms on which it was agreed that the company's affairs would be conducted or (2) if the majority shareholders exercise a legal power in a manner regarded by equity as contrary to good faith. Lord Hoffmann also recognised that unfairness could arise in circumstances similar to contractual frustration, where an event occurs which ends the basis of the shareholders' association in circumstances where it is unfair for a shareholder to insist that the association should continue.

6 The contractual based definition of unfairness in *O'Neill* has been followed in Jersey. For example, in *Robertson v Slous*,<sup>[5]</sup> Lord Hoffmann's approach was described as "equally relevant" for the purposes of article 141 but the court did not examine the policy issues upon which Lord Hoffmann based his approach and the extent to which these should influence the development of article 141. This is significant because some in England have argued that the remedy's scope is restricted by a contractual based definition of unfairness.<sup>[6]</sup> Indeed, Lord Hoffmann acknowledged this argument in *O'Neill* but stated that a balance had to be reached between the breadth of the court's discretion and what he described as the principle of legal certainty. In his Lordship's view, lawyers should be able to advise their clients whether or not a section 459 petition is likely to succeed. Lord Hoffmann also added an important caveat: there is no unfairness if a reasonable offer has been made for the petitioner's shares. The motivation for this was clear: to encourage shareholders to resolve disputes without recourse to costly litigation. If an offer has been made for the petitioner's shares, there is little benefit in pursuing litigation because the court is likely to order that either the company or another shareholder buy out the petitioning shareholder.

7 A further issue arises in Jersey with regard to the application of Lord Hoffmann's definition of unfairness. It has also arisen in Scotland and concerns the transplanting of legal concepts and principles from one jurisdiction to another. Lord Hoffmann referred to

equitable principles and good faith when defining unfairness. He did so against the background of English law and observed that “[one] of the traditional roles of equity, as a separate jurisdiction, was to restrain the exercise of strict legal rights in certain relationships in which it considered that this would be contrary to good faith. These principles have, with appropriate modification, been carried over into company law”.<sup>[7]</sup> Caution must therefore be exercised when adopting, outside of the English legal system, Lord Hoffmann’s definition of unfairness because of its distinctive jurisprudential basis. However, as Lord Hoffmann recognised in *O’Neill* when referring to constraints on legal powers, two legal systems may produce the same outcome through reliance on principles which appear different but which are functionally equivalent.

8 Lord Hoffmann has played one of the leading roles in the development of section 459. His formulation of unfairness in *O’Neill* was not revolutionary: its antecedents can be seen in his earlier decisions as a judge of the English Court of Appeal<sup>[8]</sup> and High Court.<sup>[9]</sup> During that time, practitioners and the judiciary became concerned with the length of section 459 proceedings and petitioners’ tendency to cite many allegations of unfairness in order to bolster their case. A contributory factor in this regard was imprecise judicial language, particularly the expression “legitimate expectation”, which had been used to describe those shareholder interests capable of protection under section 459. In *O’Neill*, Lord Hoffmann sought to curb the loose way in which the term was being used, observing that it “should not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the traditional equitable principles have no application”.<sup>[10]</sup> The equitable constraint is therefore the source of the legitimate expectation and not the justification for equitable intervention.

9 In England and Scotland the courts have confirmed that section 459 should not be used by shareholders to pursue interests unconnected with their capacity as a shareholder of the company.<sup>[11]</sup> In part this recognises that section 459 provides relief for shareholders in circumstances where they have no other remedy. Creditors and employees may be shareholders but they also have remedies available to them under contract and employment law. This said, Lord Hoffmann has repeatedly stressed that the *qua* member requirement should not be narrowly interpreted to include only the shareholder’s strict legal rights. This explains why section 459 has proved valuable for shareholders in small, closely companies. Shareholders in such companies are likely to be actively involved with the company’s management. Their participation may be inextricably linked with their investment and their association with the other shareholders. The parties may agree that a shareholder will be consulted or that he will participate in the company’s management as a director. But those controlling the company have the power to undermine such agreements by, for example, excluding a director or removing him from office under section 168 of the Companies Act 2006. The English courts have made clear that this can be unfairly prejudicial because it defeats an understanding, not necessarily recorded in writing, regarding the manner in which the company’s affairs would be conducted. This understanding forms part of the shareholder’s interests *qua* shareholder. As we shall now see, one of the principal questions before the Privy Council in *Gamlestaden* was the scope of the shareholder’s interest for the purposes of article 141.

## **Gamlestaden**

10 Gamlestaden was a minority shareholder in Baltic Partners Ltd. (“Baltic”), a company incorporated in Jersey and formed for the purpose of a joint venture. Gamlestaden loaned

Baltic money for this purpose and was a major creditor. Baltic became insolvent and Gamlestaden brought an action under article 141, alleging breaches of directors' duties and seeking an order that the directors pay damages to Baltic. The issue before the courts was whether to strike out the action on the grounds that there was no reasonable cause of action.

11 The Court of Appeal<sup>[12]</sup> upheld the Bailiff's decision to strike out the action on the basis that no relief could be granted which would benefit Gamlestaden *qua* shareholder; only the creditors (including Gamlestaden) would benefit. Clarke JA delivered the leading (and only reasoned) judgment in the Court of Appeal. He relied upon *Re Chesterfield Catering Co. Ltd.*<sup>[13]</sup> in which the English High Court held that it was necessary for a shareholder petitioning for the winding-up of a company to demonstrate that he would gain an advantage *qua* shareholder from the winding-up. Clarke JA believed that this formulation was "instructive as to what must be the effect of the relief sought, to which an applicant under art. 141 must be able to point, in order to establish that in granting relief the court will be protecting his interests as a shareholder".<sup>[14]</sup>

12 The Privy Council rejected the Court of Appeal's interpretation and stated that article 141 "properly construed [does] not *ipso facto* rule out the grant of relief simply on the ground that the relief sought will not benefit the applicant in his capacity as member".<sup>[15]</sup> The appeal before the Privy Council – an application for the striking out of an article 141 action – precluded a detailed analysis. Their Lordships' opinion nevertheless raises two important points with regard to the operation of the unfair prejudice remedy in Jersey and the UK: the order sought and the scope of the shareholders' interests that can be protected.

13 The order sought under article 143 by Gamlestaden was the payment of damages to Baltic in respect of harm suffered by the company. With reference to *Re Chime Corp. Ltd.*,<sup>[16]</sup> the Privy Council accepted that such an order could be made and viewed broadly the operation of article 143. This is consistent with the position in England and Scotland,<sup>[17]</sup> where it is accepted that corporate relief can be provided. This largely explains why section 459 has supplanted the derivative action in England as the principal shareholder remedy. The operation of section 459 in this regard is, however, controversial because of the long-standing principle in English law, associated most closely with *Foss v Harbottle*,<sup>[18]</sup> that the company is the proper claimant (plaintiff) where it has suffered harm. This said, Lord Hoffmann recognised in *Re Saul D Harrison & Sons plc*<sup>[19]</sup> that section 459 can be used to "outflank" this principle. The so-called *Foss v Harbottle* rule also applies in Jersey<sup>[20]</sup> and its boundaries are likely to be blurred following the Privy Council's opinion. It must, however, be noted that permitting breaches of directors' duties to form the basis for a successful action under article 141 is consistent with the concept of unfairness adopted by Lord Hoffmann in *O'Neill*. If this concept is accepted in Jersey then it follows that harm suffered by the company should be capable of being unfairly prejudicial under article 141. Indeed, the availability of relief benefiting the company in respect of the harm it has suffered is explicitly recognised by article 143, which permits the court to authorise civil proceedings on the company's behalf.

15 The second issue concerns the *qua* member requirement. Article 141 does not define the scope of the membership interest (nor do the UK's sections 459 and 994). In *Gamlestaden* it was argued that shareholders only have standing to bring an action under article 141 if the relief would benefit them *qua* shareholder. The Privy Council rejected this argument. With reference to the English decision *R&H Electric Ltd v Haden Bill Electrical Ltd.*,<sup>[21]</sup> their Lordships stated that it was "somewhat artificial to insist that the qualifying

loss for article 141 (or section 459) purposes, must be loss which has reduced the value of the investor's equity capital and that it is not sufficient to show that it has reduced the recoverability of the investor's loan capital".[\[22\]](#)

16 Their Lordships also held that "in a case where an investor in a joint venture company has, in pursuance of the joint venture agreement, invested not only in subscribing for shares but also in advancing loan capital, the investor ought not, in their Lordships' opinion, be precluded from the grant of relief under article 143(1) (or section 461(1)) on the ground that the relief would benefit the investor only as loan creditor and not as member".[\[23\]](#)

17 The Privy Council was right to reject the argument that relief could only be granted if it would benefit the shareholder *qua* shareholder and that the prejudice must have reduced the value of the shareholder's equity. If it is accepted that conduct harmful to the company's interests can be unfairly prejudicial, then there will be circumstances where the order sought under section 143 does not directly benefit the shareholders. But it does not follow, as the Privy Council's opinion implies, that if the relief does not benefit the shareholder *qua* shareholder it must benefit him in some other capacity such as a creditor. This is not required by article 141 or sections 459 and 994. For example, the company benefits directly where a director is ordered to disgorge a gain made in breach of fiduciary duty. The shareholders do not directly benefit and there is no reason why relief should be precluded on this basis because this would undermine the operation of the remedy. Moreover, shareholders' interests can be prejudiced in ways that do not reduce the value of their equity investment. The English authorities confirm this point and in *Re Elgindata Ltd.*,[\[24\]](#) a case concerning alleged mismanagement, Warner J held that a reduction in the value of equity was not the only way of establishing that conduct was prejudicial to a shareholder's interests. Actions placing the value of the shareholders' equity in jeopardy can be prejudicial.[\[25\]](#) These points were not fully explored by the Privy Council. They are important because they suggest that whether a shareholder directly benefits from the article 143 relief should not be determinative of the shareholder's standing to bring an action.

18 The most controversial part of the Privy Council's opinion is their Lordships' view that Gamlestaden's interests *qua* shareholder should include its interests *qua* creditor. Their Lordships did not expound a general rule that shareholders who are also creditors can use article 141 or section 459 to protect their interests *qua* creditor. It would be difficult to support such a rule because the purpose of the remedy is to protect the interests of shareholders in that capacity. The Privy Council nevertheless recognised in *Gamlestaden* that in some companies the nature of a shareholder's involvement and participation will not be fully reflected in the legal rights conferred *qua* shareholder. This can be supported and is consistent with *O'Neill*, in which Lord Hoffmann observed: "the requirement that prejudice must be suffered as a member should not be narrowly or technically construed".[\[26\]](#) This broad interpretation explains the success of section 459 in small, so-called quasi-partnership companies. However, the fact that the company is small, or has few shareholders, will not be sufficient for the recognition of interests and expectations beyond the shareholder's legal rights. Something more is required, as illustrated by the facts of *R&H Electric Ltd.*, upon which the Privy Council relied to support its broad interpretation of the shareholder's membership interest. When Haden Bill was formed it was agreed that a minority shareholder would participate in management for as long as a company under his control (R&H) remained a creditor. Haden Bill had been formed on the basis of mutual trust and confidence. This finding enabled the court to provide relief under section 459 where the shareholder was removed as a director. The trial judge held that the fact the shareholder and



R&H were separate did not preclude relief and that the court should take a broad view of a shareholder's interests *qua* member.

19 The facts of *Gamlestaden* were very different from those in *R&H Electric Ltd.*, not least because there was no evidence that Baltic was formed on the basis of mutual trust and confidence. It is therefore not clear on what basis the Privy Council held that Gamlestaden's interests *qua* shareholder were capable of including its interests *qua* creditor because the decisions cited by their Lordships were not fully analysed. General statements from the English cases to which their Lordships referred – such as Arden J's view that the section 459 jurisdiction has an "elastic quality"<sup>[27]</sup> – do not by themselves justify an expansive view of the shareholder's interests. Their Lordships' opinions nevertheless suggest that in a joint venture a shareholder's interests capable of protection under section 459 can include his interests *qua* creditor without the need for establishing that the relationship was formed on the basis of mutual trust and confidence.

20 The extent to which such a broad interpretation was necessary in *Gamlestaden* must be questioned because where a company has suffered harm there is nothing in article 141 (or the UK's section 994) which requires that the shareholder must directly benefit from the relief sought. Moreover, the Privy Council leaves unanswered several important questions, the most important of which concerns the arrangements that will constitute a joint venture. The joint venture appellation can accurately describe the association between many shareholders in small, closely held companies, where shareholders have subscribed for shares and provided loan capital. As such, the Privy Council's decision expands significantly the breadth of those interests which individual shareholders can protect using article 141. The difficulty is that conflicts can arise between the interests of a shareholder *qua* shareholder and *qua* creditor where, *e.g.*, a company's directors reach a decision in the best interests of the company (as a separate legal entity) but which conflicts with the interests of a loan creditor. Should article 141 be used as a forum for such disputes? Would it not be better for creditors to take action on the basis of their contract with the company?

## Concluding comments

21 The development of Jersey company law owes much to English company law, particularly in the field of shareholder remedies. *Gamlestaden* provides an excellent example but its implications reach beyond Jersey. The Privy Council has expanded the scope of article 141 and section 994 by holding that the remedy can protect a shareholder's interests *qua* creditor in the absence of a relationship of mutual trust and confidence. In Jersey the decision is likely to reduce shareholders' reliance on the derivative action and, in this regard, Jersey may see – as the UK has done – the blurring of the boundaries between conduct giving rise to a remedy for the company and that providing a remedy for the shareholder.

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[1] [2007] UKPC 26, [2007] Bus L.R. 1521, [2007] 4 All ER 164, [2007] BCC 272.

[2] See, e.g., *Albert Abela Holdings Nederland B.V. v Albert Abela Ameropa Associates Ltd. & Others* 1993 JLR 386, *Robertson v Slous* 2002 JLR 361 and *Re Northwind Yachts Ltd.* 2005 JLR 137.

[3] Section 122(1)(g) of the Insolvency Act 1986.

[4] [1999] 1 WLR 1092.

[5] 2002 JLR 361.

[6] See, e.g., the discussion in the English Law Commission's report on shareholder remedies: *Shareholder Remedies* (Law Com. 246, Cm. 3769, 1997), para. 4.11.

[7] [1999] 1 WLR 1092, p. 1098.

[8] See, e.g., *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14.

[9] See, e.g., *Re a Company (No. 004377 of 1986)* [1987] 1 WLR 102, *Re a Company (No. 007623 of 1984)* [1986] BCLC 362.

[10] [1999] 1 WLR 1092.

[11] See, e.g., *Brown v Scottish Border Springs Ltd.* 2002 SLT 1213, *Wright v J & A Mitchell & Co. Ltd.* 1996 GWD 32-1303, [1997] BCC 198 and *Re John Reid & Sons (Strucsteel) Ltd.* [2003] 2 BCLC 319.

[12] 2005 JLR 57.

[13] [1977] Ch. 373.

[14] 2005 JLR 57, at 78.

[15] [2007] UKPC 26, para. [36].

[16] (2004) 7 HKCFAR 546.

[17] See e.g., *Re Bhullar Bros* [2003] EWCA Civ 424, [2003] 2 BCLC 241, *Clark v Cutland* [2003] EWCA Civ 810, [2004] 1 WLR 783 and *Anderson v Hogg* 2002 SC 190.

[18] (1843) 2 Hare 461.

[19] [1995] 1 BCLC 14.

[20] See, e.g., *Khan v Leisure Enterprises (Jersey) Ltd.* 1997 JLR 313. For further discussion, from the perspective of English law, see Payne, "Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection" [2005] 64(3) CLJ 647.

[21] [1995] 2 BCLC 280.

[\[22\]](#) [2007] UKPC 26, para. [30].

[\[23\]](#) [2007] UKPC 26, para. [37].

[\[24\]](#) [1991] BCLC 959.

[\[25\]](#) *Re R.A. Noble (Clothing) Ltd.* [1983] BCLC 273.

[\[26\]](#) [1999] 1 WLR 1092, p. 1105.

[\[27\]](#) *Re Macro (Ipswich) Ltd.* [1994] 2 BCLC 354.